COMMISSION OF THE EUROPEAN COMMUNITIES

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Commission's Recommendation for the Broad Guidelines of the Economic Policies of the Member States and the Community

drawn up in conformity with article 103 (2) of the
Treaty establishing the European Community

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I. Broad Economic Policy Guidelines for the Community and the Member States

I.1. Main objectives and general guidelines

Contrary to expectations prevailing at the time of the adoption of the 1995 Broad Economic Policy Guidelines, the Community's economy experienced a marked slowdown in economic activity over the last twelve months and a renewed rise in unemployment. Whereas inflation declined broadly as anticipated and price convergence strengthened, progress towards sounder public finances proceeded at an insufficient pace and was made more difficult by the economic downturn.

As a result, the Community did not succeed in making significant progress towards realising important economic objectives such as those stipulated in Article 2 of the Treaty, namely the promotion of sustainable, non-inflationary growth and a high level of employment. This failure to reduce the gap between aspirations for and the realisation of economic and social well-being is the major cause of the present less confident mood in the Community.

Nonetheless, the Community enjoys quite favourable economic fundamentals. Inflation is historically low and contained, interest rates are falling, exchange rates are progressively being brought into line with underlying conditions, world trade is expanding at a healthy pace and investment profitability has been improving and, in overall terms, is noticeably higher than in the second half of the 1980s. However, rising long-term interest rates in 1994, the currency turmoil in the spring of 1995, persistent structural weaknesses and deteriorating confidence have prevented these fundamentals from asserting themselves during 1995 and early 1996. With the impact of the first two factors progressively fading out, allied with an end to destocking, expectations centre on a rebound in economic activity in the second half of this year. The pace of the expected recovery will mainly be determined by the extent to which the policy mix becomes more conducive to growth and succeeds in restoring confidence. The opportunities offered by the expected recovery should be fully seized upon to accomplish the necessary degree of convergence in order to ensure a successful transition to Economic and Monetary Union on 1 January 1999.

Meeting these challenges will primarily require a macroeconomic policy strategy geared towards growth and stability. Appropriate structural initiatives in both the goods and services markets and in the area of labour market reform should accompany and reinforce a durable rebalancing of the macroeconomic policy-mix.

In essence, therefore, the present Guidelines corroborate and augment the policy recommendations outlined in previous exercises. If this strategy does not yet seem to deliver satisfactory results in the Community at large, this is because it has been implemented with insufficient vigour and credibility. All actors are therefore encouraged to conduct their economic policies with a view to contributing to the achievement of the objectives of the Community (Article 102a of the Treaty), to demonstrate with action what has been promised since more than two years and to co-ordinate better their economic policies. The latter is not only a Treaty obligation (Article 3a) but also a practical obligation made all the more critical by the increased integration of the economies of the Member States.

It should be underlined that the present guidelines constitute not only the logical dénouement of the analyses undertaken in the context of the Commission's 1996 Annual Economic Report but also take into account the opinions prepared by the European Parliament and the Economic and Social Committee on the latter report.

I.2. Macroeconomic policy mix conducive to growth, employment and convergence

Achieving the Community objectives in terms of growth, employment and convergence will continue to require the establishment of a stable, investment-enhancing, short and medium-term macroeconomic policy mix, characterised by:

(i) a stability-oriented monetary policy;

(ii) sustained efforts to consolidate the public finances in most Member States consistent with the timetable and the objectives of the Treaty; and

(iii) nominal wage trends consistent with the price stability objective as well as real wage developments consistent with the conditions for strengthening employment-creating investment.

To relaunch the recovery process and to strengthen medium-term growth and job-creation, a durable détente of the macroeconomic policy mix is essential. The more the stability task of monetary policy is facilitated by appropriate budgetary measures and wage developments, the more monetary conditions, including exchange rates and long-term interest rates, will be favourable to growth and employment. In such a context, monetary policy can contribute substantially, in accordance with the spirit of Article 105(1) of the

Treaty, to the achievement of the Community's objectives as laid down in Article 2 of the Treaty.

High and sustained economic growth over the medium term, driven by capacity-expanding investment is essential:

(i) to reduce significantly and durably the Community's unacceptably high level of unemployment and to combat the spread of social exclusion;

(ii) to make the necessary improvement in the competitiveness, and in particular the productivity, of the Community economy compatible with the safeguarding, in the context of an open market economy, of the basic social values which characterise the Union; and

(iii) to ensure the lasting success of Economic and Monetary Union in which stability, competitiveness and employment must be assured concurrently.

Responsibility for bringing about the desired détente of the macroeconomic policy mix is assumed by three different groups of actors (central banks, national governments and the social partners). Efficient co-ordination between actors and between countries is essential in order to ensure policy consistency. The Commission will intensify its dialogue with the social partners on macroeconomic issues and invite the EMI to participate in these meetings. The social dialogue itself should also be intensified, where possible and according to prevailing traditions, at the national level.

To reinforce both the credibility of the macro-economic policy framework and the efficiency of the co-ordination process within the Community, Member States should present updated and politically strengthened convergence programmes. These programmes should clearly demonstrate that the planned policy measures to improve convergence go hand in hand with the promotion of growth and employment in the medium term. The Commission and the Council will assess their consistency at the Community level with a view to a tightening-up of the surveillance of economic policies under Article 103(3) of the Treaty.

I.3. Price and exchange-rate stability

The achievement and maintenance of a stable macroeconomic environment is a precondition for achieving sustained medium-term growth. For this purpose, and given that inflation in the Community on average is expected to fall to 2½ per cent this year, the Community should aim to keep it at this low level and to make further progress towards reaching 2 per cent.

At present, ten of the Member States already respect the objective established in previous guidelines exercises of a rate of inflation[1] of no more than 2 to 3 percent as a step towards price stability and in the United Kingdom inflation is close to 3 per cent. In the seven countries (Belgium, Germany, France, Luxembourg, the Netherlands, Austria and Finland) where inflation is below 2 per cent and in Denmark and Ireland, where it is just above 2 per cent, the anti-inflation credibility of the monetary policy framework is generally firmly established and the task is to consolidate this performance over the medium term. In Sweden, where inflation has recently come down significantly, and the United Kingdom, policies should aim at maintaining and, where appropriate, reinforcing anti-inflationary policies.

Those countries where inflation is expected to be between 3 and 5 per cent in 1996 (Spain, Portugal and Italy), should endeavour to reduce inflation further to below 3 per cent by 1997. Spain and Portugal should persevere with their existing policies with a view to achieving the desired inflation range in the near future. In Italy, the conduct of fiscal policy will in essence dictate the pace of progress with regard to the establishment of exchange rate credibility and in anchoring low inflation expectations.

Despite visible progress in Greece over recent years, it is evident that efforts must be continued and enhanced. In this regard, emphasis should be placed in particular on the maintenance of the corrective fiscal policy stance operated over the last two years as well as continuing with the prudent monetary and exchange rate policies evident since the early 1990s.

As stressed in the previous Guidelines, all Member States must continue to treat their exchange-rate policies as a matter of common interest within the framework of the European Monetary System and, where appropriate, its exchange rate mechanism. The exchange rate movements in early 1995 pointed to the need for several Member States to put their overall policy framework on a more credible footing. Policies credibly and resolutely geared towards a rebalancing of the policy mix and achieving price stability, as recommended in the present Guidelines, will not only be conducive to an appropriate alignment of exchange rates within the Community but also at the world level. For countries which are not currently participating in the exchange rate mechanism, these policies would also contribute to creating the conditions, where appropriate, for such participation.

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1 As measured by the 12 month average of the annual change in the interim indices of consumer prices.

I.4. Sound public finances

Some, but only limited, progress towards fiscal consolidation was made last year in the Community. Slippages relative to announced budgetary targets only partially reflected the adverse impact of the growth slowdown. Insufficient credibility of budgetary policies contributed importantly to the currency turbulence in the spring of 1995, sapped economic confidence and led to doubts in financial markets regarding the likelihood of a successful realisation of the Community's single currency goal.

Meanwhile, a large number of countries have taken significant steps to consolidate their public finances in 1996 and, in many cases, also in 1997. Nevertheless, the still unsatisfactory state of the public finances in the Community should lead Member States to review and, where necessary, to strengthen their fiscal consolidation plans. Credible, pre-announced and socially balanced efforts to reduce high budgetary imbalances will allow for a revival in confidence, for the transformation of the expected recovery into a durable, job-creating, medium-term, growth process and for a sound transition to EMU on 1 January 1999.

While the economic conditions are presently less favourable than anticipated at the time of the adoption of the 1995 Guidelines, a further delay in the inevitable consolidation process is not a justifiable option. Any postponement risks provoking an adverse financial market reaction and would aggravate the consolidation task in future years. In the present circumstances, a policy of allowing the automatic stabilisers to work is therefore largely inappropriate in the vast majority of Member States. Progress made in reducing structural budget deficits this year will of course persist and reinforce consolidation when cyclical conditions improve. Moreover, the adverse near-term growth impact of credible reductions in budget deficits is likely to be limited provided that the appropriate flanking conditions, in both the monetary and structural area, are set in place.

On the basis of the adjustment measures decided up until early-May 1996, the net borrowing of general government in the Community as a whole is likely to fall to just below 3½ per cent of GDP in 1997, which compares with a deficit of 5 per cent in 1995. Virtually all Member States should aim at lowering the budget deficit to, at most, 3 per cent of GDP in 1997, as a step towards the objective of close to balance in the medium term. In this respect, it is encouraging that several countries have recently announced and are implementing substantial measures to redress budgetary imbalances.

As regards the individual Member States, 12 of the 14 Member States with convergence programmes (the exception being Luxembourg) are committed to reducing their deficits to 3 per cent of GDP or below by 1996 or 1997 at the latest. Two of these countries

(Denmark and Ireland) already respect the 3 per cent budget deficit reference value and they should consequently move towards the achievement of more ambitious medium-term targets.

As regards the remaining ten countries, the additional effort needed to respect the 3 per cent reference value is undoubtedly feasible and should be pursued vigorously. Within this group, several countries (Germany, France, Austria, Finland, Sweden) have this year announced substantial measures or reinforcements with a view to achieving a reduction in their budget deficits to 3 per cent of GDP or less in 1997. These countries, as with the Netherlands, should resolutely implement their programmes of fiscal consolidation and, if necessary, strengthen them in order to ensure that their objectives are fully met.

In Belgium both the impact of weaker-than-anticipated output growth on tax revenues and social transfers and the non-recurrent nature of some of the measures previously taken require supplementary efforts to respect the 3 per cent reference value in 1997. The Belgian government is firmly committed to specifying the necessary measures during the preparation of its 1997 budget in June-July of 1996. In the United Kingdom, substantial reductions in the budget deficit are expected to continue over the next two years mainly as a result of planned expenditure restraint. But to respect the convergence programme targets, further action is needed both to compensate for the fiscal slippage in 1995 and an expected less rapid budgetary improvement in the short run which is partly due to lower growth than previously predicted. Finally, in Spain and Portugal, a determined implementation of the budgetary component of the convergence programmes is required, with special attention to be given in Spain to a re-evaluation of the social security system.

With regard to the two remaining Member States, Italy needs to introduce significant measures to achieve and improve upon the planned budgetary consolidation which remains the central policy priority in terms of restoring market confidence. Action should primarily focus on the fight against tax evasion, on greater budgetary discipline of local authorities and on improved efficiency of the public administration. As regards Greece, sustained efforts on a wide range of fronts, most notably a continuation of the existing privatisation initiatives, an expansion of the tax base and current expenditure reductions, are all required.

Although the extent, timing and design of consolidation measures need to be tailored to country-specific conditions, some general principles have been identified in previous Guidelines exercises. These include:

(i) restraining expenditure increases, as opposed to further increases in the overall tax burden, is widely regarded as a more credible and efficient option. Among the issues which should be addressed are the need to place pension provisions on a sustainable footing, to curb the rise in health care costs and to reduce distortionary and costly subsidies.

(ii) re-directing, to the greatest extent possible, government spending towards productive activities such as investment in infrastructure, human capital and active labour market measures, while not endangering the necessary reduction in budget deficits;

(iii) improving the efficiency of public services through *inter alia* more flexible management practices, better incentives for public employees, and in some cases increased use of privatisation and user-fees to the extent that Member States judge it compatible with their objectives;

(iv) ensuring that a reduction in the overall tax burden, which is desirable in most Member States, is conditional upon initially putting the budget deficit on a firm downward path. In the interim, however, Member States stand to gain from a broadening of the tax base and a modification in tax structures so as to reduce the tax burden on labour. In particular, reductions in non-wage labour costs at the lower-end of the wage scale should be considered.

I.5. Better functioning of product and service markets

To foster growth, and thus employment, whilst maintaining low inflation, it is essential that action on the macro side is added to by measures aimed at ameliorating the functioning of product and service markets in general and at generating higher competition and a more flexible functioning of the price mechanism in particular. This will essentially require a further reinforcement of competition policies and a curbing of state aids in full respect of the objectives of Article 130a of the Treaty concerning economic and social cohesion.

It is also crucial to fully exploit the internal market potential in an open and competitive environment through the transposition into national law and effective enforcement of single market legislation. In sectors where transposition is lagging behind, a particular effort is needed to present all necessary proposals to national parliaments before the end of 1996.

To enhance the Community's competitiveness, measures aimed at promoting innovation, at favouring the emergence of the information society and at achieving a working environment more conducive to initiative and to the development of SMEs should be swiftly implemented. Of course, in these areas the individual Member States largely hold the key. However, the potency and effectiveness of national actions, which are essential, can be significantly added to via co-ordination and appropriate actions at the Community level. At this level, among the wide range of activities currently being pursued, specific attention should be given to a number of recent proposals of the Commission. Action to remove the remaining obstacles to the effective implementation of the TENs projects should be initiated. Further work is also needed to ease the impediments currently hampering the development of the SME sector. A more co-ordinated R & D effort is required both at the level of the Member States themselves and between the latter and specific EC-funded research programmes. The Commission will also pursue its policy to improve competition in EU-markets. Finally, to increase the job-creating potential of environmental policies, these policies should -- to a greater extent than at present -- rely on market-based instruments, including fiscal ones, both at the national and Community levels.

I.6. Fostering employment and labour market reforms

More than 2½ years after the publication of the Commission's White Paper on Growth, Competitiveness and Employment and with the Essen employment strategy set in place for some time, the Community finds itself with a dismal employment record over the period in question. Although the expected recovery will lead to renewed job creation and will reverse the current upward trend in unemployment, it is likely that more than 17 million people will still be unemployed in 1997 in the Community. Assuring a sustained and significant improvement in employment and unemployment requires not only durable, high, economic growth and efficient product and service markets, but also a broad range of labour market reforms.

Eliminating existing rigidities as well as ensuring a more efficient operation of labour markets is at the heart of national efforts to ensure both a tension-free and stronger medium-term expansion and a more employment-creating growth pattern. Member States have been making efforts to reform their labour markets. They are encouraged to intensify their actions while ensuring both equity and efficiency in the social protection system. The implementation of policies aimed at improving the occupational and regional mobility of the labour force and at enhancing the efficiency of employment services should reduce bottlenecks which could lead to an early end to the growth process.

Suitable policies should be conducted in order to adapt the whole educational system -- including vocational training -- both to the needs of markets and to the improvement of human capital, thereby fostering the growth potential of the economy. In this respect, priority should be given to enhancing the employability of young people, women and the unemployed, in particular low skilled, inexperienced labour, and to reducing skill mismatchs on the labour market by providing training better fitted to the changing needs of the labour market.

A higher labour-content of growth should be favoured by the maintenance of appropriate average wage trends and in some cases by a larger wage differentiation according to qualifications, regions and, to some extent, sectors and firms. A reduction in the labour costs of low-productivity jobs, either through direct wage developments (e.g. by introducing entry wages in appropriate cases) or through a targeted reduction in non-wage labour costs, should increase the incentives to the employment of low-skilled labour. Such measures should be compatible with Community competition policy. Adaptations, at the firm level, of working-time and work organisation will also act in this direction. Finally, the promotion of local and regional initiatives in the field of new services containing a high labour-intensive dimension, such as those identified in the Communication from the Commission on a European strategy for encouraging local development and employment initiatives, should also be encouraged.

All the above elements are featured in the Community's common employment strategy, initiated at the Essen European Council and refined subsequently at both the Cannes and Madrid Councils. The procedures adopted at these European Councils need to be made more efficient. In this respect, Member States' multi-annual employment programmes must be developed further, to make them more effective instruments in the area of labour market policy. Furthermore, the Commission's initiative to mobilise all actors around the top priority of fighting unemployment is aimed at making maximum use of the existing instruments at the level of the Union.

II. EXPLANATORY MEMORANDUM

II.1 Progress report on the implementation of the 1995 Broad Economic Policy Guidelines

II.1.1. Introduction

In conformity with the Maastricht Treaty, Broad Economic Policy Guidelines were adopted in December 1993, July 1994 and again in July 1995. Following mandates from the European Council, the implementation of the 1993 Guidelines was assessed in December 1994. The execution of the 1994 Guidelines was examined on two separate occasions, once in December, and again in June 1995.

This document reviews, following a request from the Cannes-European Council, the progress made in implementing the 1995 Broad Economic Policy Guidelines[2] since their adoption by the EcoFin Council in July of last year. In an attempt both to streamline the surveillance procedures and to present the necessary information and analysis for the adoption of the new guidelines, an assessment of the past guidelines will henceforth form an integral part of the Commission's explanatory memorandum. Such an assessment constitutes a valid test of the degree of commitment of the individual Member States to shared policy responsibilities. Because of the medium-term orientation of economic policies, this report examines trends evident since the adoption of the first guidelines Recommendation in 1993.

The policy issues raised in the 1995 Guidelines were addressed against a background where the economic recovery process, which commenced towards the second half of 1993, had apparently become firmly established. The pace and composition of the economic expansion in 1994 had given rise to optimism that growth rates of the order of 3 per cent could be realised in both 1995 and 1996.

Since then, however, there has been a marked slowdown in growth. An extended analysis of the factors behind the slowdown was presented in the Commission's 1996 Annual Economic Report with only the key points of that analysis being summarised here. The quarterly rates of GDP growth of the order of 3½ to 4 percent (annualised rate) witnessed throughout most of 1994 decelerated to around 2 percent in the second and third quarters of 1995 culminating in virtual stagnation in the last quarter of last year. This lower than expected output performance was reflected in adverse labour market developments. The

2 An initial review of the 1995 guidelines took place in December 1995.

moderate rise in overall employment in the Community since the middle of 1994 came to a standstill towards the end of 1995. Particularly in the countries which were hardest hit by a worsening in their competitive position following the exchange rate crisis of spring 1995, employment trends turned markedly negative. But also in several other countries, the economic slowdown brought employment gains to a halt. In sum, employment is estimated to have grown by only ½ a per cent last year in the Community as a whole.

Apart from the fading of the initial impulse from stockbuilding, the significant slowdown during 1995 essentially reflected two adverse developments in financial markets. Firstly, the marked rise in long-term interest rates on world and Community financial markets during 1994 appear to have exerted a stronger-than-expected restraining influence on companies' and households' spending decisions in 1995. The rise in yields varied considerably across EC Member States, reflecting *inter alia* their economic performance, policy stance and credibility. In particular, long-term interest rates rose significantly more in countries whose public finances were not yet perceived by the markets as having been put on a clearly sustainable downward path.

Table 1

Nominal interest rates

(per cent)

	Dec. 1993	Dec. 1994	April 1995	Jan. 1996	April 1996	Dec. 1993	Dec. 1994	April 1995	Jan. 1996	April 1996
	Short-term[1]					Long-term[2]				
B	7.2	5.4	5.3	3.6	3.3	6.6	8.3	7.9	6.5	6.7
DK	7.3	6.2	6.9	4.4	4.0	6.2	8.8	8.8	7.0	7.3
D	6.1	5.3	4.6	3.5	3.3	5.7	7.5	7.1	5.9	6.4
GR	19.9	17.9	17.2	14.6	14.1	:	:	:	:	:
E	8.9	8.2	9.4	8.9	7.8	8.3	11.5	12.1	9.5	9.3
F	6.5	5.9	7.7	4.7	3.9	5.8	8.1	7.8	6.5	6.5
IRL	6.3	6.3	6.8	5.4	5.1	:	8.6	8.7	7.2	7.6
I	8.6	9.0	10.8	9.9	9.4	8.8	11.9	13.0	10.2	10.1
NL	5.6	5.4	4.7	3.3	2.9	5.7	7.6	7.2	5.9	6.4
A	5.8	4.8	4.5	3.7	3.0	:	7.6	7.4	6.2	6.5
P	11.7	10.5	10.8	8.5	7.6	9.0	11.5	12.1	9.4	9.2
FIN	5.9	5.7	6.0	4.2	3.9	:	10.3	9.4	7.0	7.5
S	7.7	8.2	8.9	8.4	6.6	:	10.7	11.5	8.3	8.4
UK	5.3	6.4	6.7	6.4	6.0	6.3	8.5	8.4	7.4	8.1
EUR	6.9	6.6	7.2	5.8	5.3	(6.8)	(9.0)	(8.9)	7.3	7.6

[1] Three-month money market rate.
[2] Yield on benchmark 10 year bonds, unless for EUR until April 1995 where data refer to yields on government bonds..
Source: Commission's Spring 1996 forecasts.

Secondly, and perhaps more importantly, the currency turmoil in the spring of 1995 had a significant impact on the economies of the appreciating as well as the depreciating countries. It was triggered by a marked weakening of the US-dollar in the wake of the Mexican Peso crisis. But the subsequent sizeable and abrupt movements between EC currencies seem to reflect the deeper, underlying, problem of the lack of credibility of national budgetary consolidation plans and structural reforms and/or perceived risks of renewed inflationary tensions in a number of individual Member States. In Germany and the countries whose currencies are closely linked to the DM, the appreciation of the exchange rate implied a considerable tightening of overall monetary conditions, in spite of an easing in short-term interest rates, and a worsening of competitiveness and industry profitability. This in turn had knock-on effects on investment and led to a marked deterioration in business confidence. On the other hand, in countries whose currencies depreciated significantly, the short-term boost to export market shares was to some extent offset by lower growth on export markets, and by rising interest rates and the erosion of consumer purchasing power from higher inflation on the home market. Furthermore, at the level of the Community as a whole, sizeable and abrupt intra-Community exchange rate movements jeopardise the proper functioning of the internal market, leading inevitably to suboptimal resource allocation.

Table 2

Nominal effective exchange rates

Index, August 1992 = 100

	Dec. 1993	Dec. 1994	April 1995	Jan. 1996	April 1996
B	99.9	103.3	107.9	105.9	104.6
DK	100.5	102.2	107.2	106.8	105.4
D	100.8	103.1	109.3	106.7	104.9
GR	87.5	82.9	82.9	80.2	80.9
E	78.4	76.2	77.1	80.6	80.2
F	100.9	102.4	106.3	106.7	106.0
IRL	92.8	94.5	93.3	94.3	94.6
I	75.1	72.7	63.2	71.6	73.9
NL	102.6	104.3	109.0	107.0	105.8
A	101.5	102.8	107.3	105.5	104.2
P	87.2	86.3	90.2	89.6	89.3
FIN	82.5	91.5	95.8	95.8	91.1
S	74.6	77.5	73.0	83.2	84.8
UK	88.7	87.1	83.2	82.1	82.4
EUR	76.2	80.2	80.4	84.6	83.6

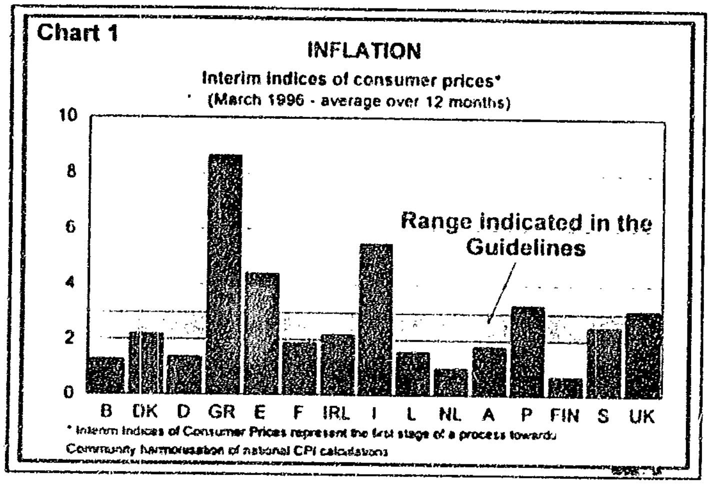
Source: Commission

The above developments point to the need for increased policy co-ordination at the international level. They also clearly highlight the adverse impact on growth, employment and confidence of insufficient actions in those policy areas, directly under Member States' own responsibility, needed to further rebalance the policy-mix as recommended in the 1995 Broad Economic Policy Guidelines.

The progress review given below follows the four broad headings used in the Council Recommendation namely: price and exchange rate stability; sound public finances; competitiveness and employment and the labour market.

II.1.2. Price and exchange rate stability

stability -- The 1995 Guidelines reaffirmed the objective, set in the 1993 and 1994 exercises, of a ***rate of inflation of no more than 2 to 3 percent***, as a step towards price stability, adding that this target was likely to be achieved in the majority of Member States in 1996.



Inflation has been on a steady downward trend in the Community since 1991 with the rate of increase of the deflator of private consumption falling from around 5½ percent to a little over 3 percent last year, with most Member States achieving the inflation objective already in 1995. As regards developments so far in 1996, consumer price inflation in the Community in March of this year, as measured by the 12 month average of the annual change in the interim indices of consumer prices (IICPs)[3], stood at 2.9 percent. In ten of the Member States, inflation was within the range indicated by the Guidelines and in the majority of them the rate of inflation even stood at below 2 per cent. In the United Kingdom, inflation was close to 3 per cent. Of the remaining Member States, Portugal has come relatively close to the range in recent months. In Spain and Italy, inflation is falling visibly following last year's blip which reflected the combined impact of their currency depreciations and increases in indirect taxes. Finally, further marked progress was achieved last year in Greece but the disinflation process seems to have lost momentum in recent months. However, this development is related to exogenous factors.

This relatively encouraging inflation performance since the adoption of the Guidelines reflects the combined impact of several forces. It incorporates not only influences such as a persistent, and even widening, negative output gap and subdued raw material price developments but also structural improvements in such areas as central bank independence, wage behaviour and competition. The notable success in bringing inflation down in several Member States and appropriate actions by the monetary authorities in countries whose currencies depreciated, has led to an enhanced credibility of anti-inflationary policies. Wage developments were fairly moderate last year broadly moving in line with

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3 These IICPs represent the first stage of a process towards harmonisation of CPI calculations. The IICPs and the subsequent HICPs (Harmonised Indices of Consumer Prices), which will commence in January 1997, will be used in the context of the evaluation of compliance with the Maastricht inflation criterion.

price increases in most Member States, with nominal compensation of employees per head accelerating mildly to 3½ percent in the Community as a whole. This figure compares with an annual average rate of increase of close to 6 percent over the period 1991-93. Real unit labour costs contributed to improved profitability by declining by about 1 per cent or more in many Member States and by 1.3 per cent in the Community as whole, thereby respecting the Guidelines recommendation.

Table 3

Inflation developments

(% change p.a.)

	Private consumption deflator			Nominal compensation of employees per head			Real unit labour costs		
	1993	1994	1995	1993	1994	1995	1993	1994	1995
B	3.1	3.0	1.5	3.3	4.8	1.9	-0.4	-0.7	-1.5
DK	0.3	1.7	1.8	1.6	3.6	3.3	-1.5	-3.0	0.5
D	3.9	2.7	2.0	4.3	3.2	3.8	-0.1	-2.6	-0.7
GR	13.7	10.8	9.3	10.1	11.9	12.5	-0.4	1.3	1.9
E	5.5	4.9	4.6	6.5	3.1	2.4	-0.5	-3.4	-2.6
F	2.2	1.8	1.6	2.2	2.1	2.4	0.1	-1.9	-0.3
IRL	1.7	2.7	2.5	4.9	3.2	3.1	-1.7	-2.0	-2.6
I	5.4	4.6	5.7	3.7	3.0	5.2	-2.4	-4.0	-3.1
L	7.0	2.4	2.0	5.2	3.4	3.9	-2.6	-0.9	-0.8
NL	2.3	2.4	1.1	3.1	2.3	3.0	0.6	-2.5	-0.1
A	3.4	3.0	2.2	4.6	3.1	3.8	0.3	0.6	-0.3
P	7.1	5.2	4.2	9.1	5.2	4.6	0.8	-1.4	-3.5
FIN	4.2	1.3	1.1	1.0	3.5	5.3	-6.6	-2.9	-0.4
S	5.7	3.1	2.7	4.4	5.4	3.0	-1.4	-1.1	-2.4
UK	3.5	2.5	2.6	4.3	3.5	3.1	-2.6	-2.4	-1.0
EUR	4.1	3.2	3.0	4.0	3.2	3.5	-1.0	-2.5	-1.3

Source: Commission's Spring 1996 forecasts.

Nevertheless, in some countries wage trends were disappointing; not only in those where the disinflation process has not yet been completed but also for instance in Germany where wage settlements were relatively high compared with the stated inflation objective of the monetary authorities. Together with the appreciation of the DM, these wage agreements contributed to the erosion of competitiveness and profitability in the internationally exposed sectors. In Italy, wage costs accelerated in 1995 but the rate of increase remained slightly below inflation. Continued vigilance is necessary to avoid the development of a wage-price spiral which, if it were allowed to get hold, would raise the future costs of achieving price stability. In Finland, wages rose significantly in both nominal and real terms in 1995. However, due to the moderate two-year incomes policy agreement, the rise in wages and salaries will decelerate substantially in 1996 and 1997.

Exchange rate stability -- Following the exchange rate turmoil of Spring 1995, a broad degree of stability slowly began to re-emerge over the months to September 1995. Among the factors contributing to this process was a strengthening of the US dollar in the months through to August, a monetary easing by the Bundesbank in March and reinforced efforts at budgetary consolidation in several Member States. This benign situation was to some extent interrupted in September with a renewal in exchange rate volatility amongst European currencies. The factors responsible for this re-emergence of tensions included a renewed weakening of the dollar and specific economic and political factors in a number of Community countries allied to a resumption of concerns with regard to the prospects for EMU. However, despite this interruption, calm has returned to the markets with the currency movements in the period 1994-95 having been largely reversed in the early months of this year.

The currencies of Greece, Italy and the United Kingdom have continued to be outside the ERM. Of the three new Member States, only Austria entered the ERM at the beginning of 1995.

Developments in relation to short- and long-term interest rates in 1995 in part reflected the tensions on the foreign exchange markets. The Bundesbank cut the discount rate on four occasions since March 1995 against the background of slow money supply growth and better inflation prospects in Germany, thereby providing most other Member States with the necessary room to follow suit. Having widened sharply amid the exchange rate tensions in the spring, short-term interest rate differentials with respect to corresponding rates in Germany narrowed in most Member States in the course of 1995. The pace of narrowing in differentials has varied among Member States and has in most cases reflected developments in their exchange rates against the DM. Significant differentials remain in several Member States where financial markets remain concerned at the credibility of anti-inflation and/or budgetary policies.

At the long end of the market, the sustained decline in interest rates in 1995 (following the increase in 1994) was sharply reversed in the early months of this year. The recent rise across the Community largely reflects spillover effects from developments in the United States, where evidence of buoyancy in the economy has been seen as heightening the possibility of a monetary tightening by the Federal Reserve. As with short-term interest rates, the trend in differentials between Germany and other Member States has been generally downward, although substantial differentials persist in some Member States where exchange rate credibility remains closely tied to inflation and/or budgetary developments.

II.1.3. Sound public finances

Many countries came out of recession in 1993 with serious budgetary imbalances. The need for urgent action in this area was recognised in the earlier Guidelines exercises. Unfortunately, many Member States, despite the relatively good economic conditions prevailing in 1994 and early 1995, had not made substantial inroads into their budgetary problems at the time of last year's Guidelines exercise.

The public finance objectives of the 1995 Guidelines were that in the short run Member States should not only rely on the positive benefits which were expected from the workings of the automatic stabilisers to improve their budgetary positions but that they must also take full advantage of all the growth opportunities to step up fiscal consolidation by reducing structural deficits. Member States were urged to reduce their budget deficits to below 3 percent of GDP as soon as possible. Any additional room for manoeuvre provided by stronger than expected growth or a more favourable interest rate evolution was recommended to be used to accelerate the process of budgetary consolidation.

Developments in 1995 -- In overall terms, the budgetary position of a large majority of the Member States registered some progress in 1995. However, the degree of improvement was insufficient given both the extent of the fiscal difficulties to be surmounted and the official commitments to do more. The sharp cyclical slowdown experienced in some Member States over the course of the year, and especially in the last quarter of 1995, obviously made progress towards sounder public finances more difficult. However, fiscal slippages in several countries were a clear factor behind the overall insufficient improvement in the underlying budgetary positions, as measured by the Commission services estimates of the cyclically-adjusted budget balances.

In fact, general government net borrowing in the Community in 1995 came down by only half of a percentage point to a still unacceptably high level of 5 percent of GDP, which is substantially higher than the figure anticipated at the time of the drafting of the Guidelines in May of last year. Of the budgetary adjustment which took place, roughly half of the improvement was due to non-cyclical factors; the estimated reduction in the cyclically-adjusted budget deficit (¼ of a percentage point) was smaller than expected earlier.

At the level of actual budget deficits, ten of the fifteen Member States have registered some progress in 1995, varying from gains of ½ a percentage point in the case of Portugal to nearly 3 percentage points in Greece. Nine of these ten countries also registered an improvement in their structural deficits. The exception was Finland where the widening in the adjusted deficit was mainly explained by the timing of tax repayments. Four countries, namely Denmark, Greece, Italy and Sweden, achieved improvements in their cyclically-adjusted deficits of between 1 and 3 percentage points. All the latter four Member States, with the exception of Denmark, still have deficits well above the 3 per cent of GDP reference value at the start of 1996. Belgium, Spain, France and the United Kingdom achieved discretionary reductions of the order of a ½ to ¾ of a percentage point.

Table 4

Actual and cyclically-adjusted general government budget balances
(per cent of GDP)

	Actual budget balance (level)			Change in actual budget balance[1]			Change in cyclically-adjusted balance[1]		
	1993	1994	1995	1993	1994	1995	1993	1994	1995
B	-6.7	-5.3	-4.5	0.4	1.4	0.8	2.6	1.2	0.5
DK	-3.9	-3.5	-1.4	-1.0	0.4	2.1	-0.7	-1.3	1.6
D	-3.5	-2.5	-3.5	-0.7	1.0	-1.0	1.0	0.8	-0.9
GR	-14.2	-12.1	-9.2	-1.9	2.1	2.9	-0.9	2.2	2.6
E	-7.5	-6.9(2)	-6.2(2)	-3.3	0.6	0.7	-1.1	0.7	0.4
F	-6.1	-5.8	-5.0	-2.0	0.3	0.8	-0.4	-0.4	0.5
IRL	-2.4	-2.0	-2.4	0.1	0.4	-0.4	1.3	-0.5	-2.0
I	-9.6	-9.0	-7.1	0.0	0.6	1.9	1.4	0.4	1.3
L	1.8	2.2	0.3	1.0	0.4	-1.9	:	0.1	-2.0
NL	-3.2	-3.2	-3.4	0.7	-0.0	-0.2	2.3	-0.3	-0.2
A	-4.3	-4.5	-6.2	-2.2	-0.2	-1.7	-1.4	-0.5	-1.6
P	-7.1	-5.8	-5.4	-3.7	1.3	0.4	-2.2	1.8	0.2
FIN	-8.0	-6.3	-5.6	-2.2	1.7	0.7	-0.7	-0.3	-1.2
S	-12.3	-10.8	-8.1	-4.5	1.5	2.7	-1.7	0.3	1.1
UK	-7.8	-6.8	-6.0	-1.5	1.0	0.8	-1.5	0.1	0.6
EUR	-6.2	-5.5	-5.0	-1.1	0.8	0.5	0.2	0.3	0.3

1) Commission services estimates. A "+" indicates an improvement; a "-" indicates a deterioration in the budget balance.
2) This time series includes social security contributions still on a cash basis. Preliminary accounting on an accruals basis by national sources shows figures of -6.2 per cent of GDP for 1994 and -5.8 per cent of GDP for 1995. The time series will be updated on an accruals basis once certain issues concerning the correct application of statistical definitions have been clarified.
Source: Commission's Spring 1996 forecasts.

The five remaining countries experienced a worsening in both their actual and cyclically-adjusted budget deficits. As regards cyclically-adjusted budget balances, deteriorations of around a ¼ of a percentage point were registered in the Netherlands, ¾ of a percentage point in Germany and between 1½ and 2½ percentage points in Ireland, Luxembourg and Austria. In the case of Germany, the overrun was partly due to unexpected revenue weakness. In Ireland, against a background of strong growth, policy appears to have been pro-cyclical although special factors, such as the social security settlement, were also at play. Despite some slippage, Luxembourg, as with Ireland, still respects the Maastricht budgetary reference value. Finally, in Austria although the new government is tackling the problem, it is clear that there was a serious budgetary deterioration in 1995. Efforts to reverse the structural deterioration which occurred last year are appropriate in all these five Member States but are especially necessary in those countries with cyclically-adjusted deficits in excess of 3 per cent of GDP.

On a more positive note, the bulk of the fiscal adjustment which took place over the last two years was centred on the spending side, with the share of government expenditure in GDP falling by about 1¾ percentage points in the Community as a whole, though remaining above 50 per cent of GDP. A drop in the government spending ratio was a common trend amongst a large majority of Member States. Furthermore, in all countries, with the exception of Portugal, there was a decline in non-interest expenditure.

Table 5

Receipts, expenditures and interest payments of general government

(in % of GDP)

	Receipts			Expenditure			(of which) Interest payments		
	1993	1994	1995	1993	1994	1995	1993	1994	1995
B	49.6	50.4	49.9	56.3	55.6	54.4	10.5	10 2	9.2
DK	58.3	58.8	58.3	62.2	62.3	59.7	7 8	7 1	6.7
D	46.5	46.8	46.3	50.0	49.3	49.8	3.3	3 4	3.8
GR	34.4	35.8	36.8	48.5	48.0	46.0	12.8	14 2	12.9
E	42.0	41.0	39.9	49.5	47.9	46.0	5.2	5 1	5.4
F	49.3	48.9	49.3	55.5	54.7	54.3	3.7	3 8	3.7
IRL	38.9	39.5	37.3	41.3	41.6	39.7	6.7	5.9	5.2
I	47.4	45.2	44.8	57.0	54.2	51.8	12.1	10 7	11.2
L	45.0	44.6	41.6	43.2	42.4	41.3	0.4	0.4	0.3
NL	53.1	50.8	48.6	56.3	54.1	51.9	6.4	6 1	5.8
A	49.4	48.1	46.9	53.7	52.6	53.1	4.3	4 1	4.3
P	36.3	38.0	39.4	43.4	43.8	44.8	6.7	5 8	5.8
FIN	53.8	54.6	52.8	61.9	60.9	58.4	4.6	5.1	5.4
S	60.3	59.6	59.5	72.6	70.4	67.6	6.2	6 8	7.1
UK	35.9	36.4	37.6	43.7	43.2	43.6	2.9	3 3	3.7
EUR	46.2	45.9	45.7	52.5	51.4	50.8	5.5	5 3	5.4

Source: Commission's Spring 1996 forecasts.

As regards government receipts, a moderate decline was noticeable in the Community as a whole and in several Member States. A rather marked drop in the proportion of government receipts to GDP occurred in the Netherlands, Austria and Luxembourg over the last two years. Conversely, the tax burden showed a rising tendency in Greece, France, Portugal and the United Kingdom.

The insufficient degree of progress in reducing the Community's government budget deficits was reflected in the average debt/GDP ratio figures for the Community which increased in 1995 by three percentage points to over 71 percent. While the inclusion in the German figure of the unification-related debt take-over by the German federal government, essentially the Treuhand-anstalt, was clearly an important factor in explaining the increase for the Community as a whole, it should be noted that the debt-to-GDP ratio continued to worsen in a total of 9 Member States in 1995. In Luxembourg and Finland the debt ratio did not change, whereas Denmark, Belgium, Ireland and Italy managed to reduce their debt ratios by between almost 1 and 6 percentage points. Finally, it should be stressed that rising debt ratios in a majority of Member States at a time of overall budgetary improvement demonstrates the need for an intensification of fiscal retrenchment efforts.

Table 6

Gross government debt
(per cent of GDP)

	1993	1994		1995	
	Level	Level	Annual Change	Level	Annual Change
B	137.9	136.0	-1 9	133 7	-2 3
DK	80 1	76.0	-4 1	71 9	-4 1
D	48 2	50.4	+2 2	58 1	+7 7
GR	111 8	110 4	-1 4	111 5	+1 1
E	60 5	63 1	+2 6	65 7	+2 6
F	45 4	48 3	+2 9	52 4	+4 1
IRL	97 5	91 1	-6 4	85 5	-5 6
I	119 4	125.6	+6 2	124 8	-0 8
L	6 2	5 9	-0 3	5 9	0 0
NL	81 1	77 6	-3 5	79 0	+1 4
A	62 8	65 0	+2 2	69 4	+4 4
P	67 2	70 0	+2 8	71 6	+1.6
FIN	57 3	59.5	+2 2	59 6	0.0
S	76.0	79 3	+3 3	79 9	+0 6
UK	48.5	50 2	+1 7	54 0	+3.8
EUR	66 2	68 2	+2.0	71 2	+3 0

Source: Commission's Spring 1996 forecasts

In overall terms therefore, the contribution of discretionary fiscal consolidation has been less than had been hoped for in 1995. This failure to fully realise earlier expectations is disappointing given that the importance of making steady progress towards meeting the fiscal convergence criteria has been publicly acknowledged by Member States in their national convergence programmes. It is also disappointing given the extent of the fiscal divergence which continues to persist, as reflected in the EcoFin Council decisions with regard to the existence of Treaty-defined

Table 7

Government deficits in 1995: Convergence programme (CP) projections and latest Commission (COM) forecasts

	Date	CP(a)	COM
B	6/92 (6/94)	3.8 (4 3)	4 5
DK	11/94	3.0	1 4
D	11/93	2 to 3	3 5
GR	6/94	10 7	9 2
E	7/94	5.9	6 1
F	11/93 (7/95)	4.2/4 1 (5 0)	5.0
IRL	6/94	<3	2 4
I	9/92 (6/95)	4.7 (7 5)	7 2
NL	10/94	3.7	3 4
A	5/95	4 ½	6 2
P	11/93 (10/94)	3 ¼ (b) 5.8)	5.4
FIN	9/95	5 3	5 6
S	6/95	9 0	8 1
UK	3/95	3 ¾ (c)	6 0

a) Figures in brackets are revised official targets, not submitted as convergence programmes at Community level
b) Average for 1995-97.
c) Financial year 1995/96.
Source: Commission's Spring 1996 forecasts

excessive deficits.

Budgetary outlook -- The crucial task facing a large number of countries is to continue to make progress towards putting their public finance positions onto a firmer footing. With regard to actual budget deficits, the vast majority of countries are forecast to reduce their deficits in 1996. Nevertheless, on the basis of concrete measures announced so far and the more prolonged than expected pause in the recovery, progress would appear insufficient when compared with the targets set both in the Guidelines and in national convergence programmes. 'Only 3 Member States (Denmark, Ireland and Luxembourg) are now likely to have deficits below the 3 percent reference value this year compared with an expectation of 7 countries at the time of the adoption of the 1995 Guidelines.

Since the adoption of the Guidelines in July 1995, almost all the Member States have announced new budget proposals for 1996 and, in some cases, for 1997. These proposals all aim for further reductions in government deficits this year and next, to 3 per cent of GDP or below by 1997 at the latest in all countries except Greece and Italy. Particularly sizeable packages of adjustment measures were announced by the governments in Belgium in September 1995 (tax increases and expenditure cuts), Finland in September 1995 (expenditure cuts in 1996 and 1997, Italy in September 1995 (measures to fight tax evasion, increases in social security contributions and cuts in transfers to non-government institutions), France in August 1995 (fiscal measures to reduce the central government deficit), in November 1995 (fundamental reform of the social security system) and in May 1996 (expenditure cuts and restoration of social security account), by the newly formed government in Austria in April 1996 (expenditure cuts, tax increases and reform measures aimed at the pension system) and by the German government also in April 1996 (expenditure cuts).

Slower economic growth, on average in 1996, than expected when most of these budget plans were drawn up is making deficit reduction more difficult this year. Several Member States have already announced additional measures (e.g. freezes on certain expenditure items in Germany and France) to offset some of the slippage caused by the impact of the weaker growth on tax revenues and social transfers, and others are likely to do so in the coming months.

Provided that all the measures which have been decided are fully implemented by the respective Member States then a substantial correction of underlying budgetary positions is in prospect. However, it must be reiterated that, while these measures are clearly welcome, in a number of cases they are still insufficient in relation to both the size of the problem to be addressed and the targets set in national convergence programmes.

II.1.4. Competitiveness

The 1995 Guidelines reiterated the importance of implementing reforms aimed at strengthening the underlying growth forces and enhancing the dynamism and competitiveness of the Community economies.

It is clear that the major onus is on the individual Member States to provide the conditions in which a truly competitive environment can be established and sustained. This can only be done by correctly focusing economic, fiscal and social policies in order to ensure that they continue to remain consistent with the Member States objectives in this area. These national efforts need however to be complemented and reinforced by action at the Community level.

At the Community level, the importance of fully exploiting the opportunities provided by the internal market needs to be continuously stressed. As of April 1996, the global rate of transposition of internal market Directives was 89.7 percent. Denmark has the highest rate of transposition (96.6 %) followed by the Netherlands, the United Kingdom, Luxembourg and Spain. The sectors which continue to present the most problems in terms of the implementation of White Paper directives are public procurement, insurance and intellectual and industrial property.

Action on the competitiveness front is being intensified in the context of the Commission's recent proposal for a Confidence Pact for Employment to reinforce efforts in the particular areas of research and development, Trans-European networks and in encouraging dynamic small and medium-sized enterprises (SMEs).

This initiative by the Commission reinforces the actions already taken in the Community in a large number of areas dealing with competitiveness. The Community has continued its efforts over the last number of years to complement the single market initiative by setting in place an effective competition framework to ensure the successful operation and efficiency of Member State enterprises. The following are the most important developments:

- The Commission presented important initiatives in the area of telecommunications last year with the objective to ensure a greater liberalisation of the regulatory framework. Such liberalisation is crucial to the Community's ambitions in relation to the Information Society. The implementation of full competition in telecommunications markets affects the competitiveness of the whole Community economy. The Commission also presented initiatives concerning the Community's postal services.

- Competition policy has also been taking on growing importance in boosting the competitiveness of the Community's industries. In 1995, the Commission has reviewed the Community frameworks for aids to SMEs, to shipbuilding and to R&D.
- Action has been undertaken in the area of legislative and administrative simplification.
- The Competitiveness Advisory Group, consisting of high level experts and industrialists, presided over by Mr Ciampi, was nominated by the Commission and presented a report to the Madrid European Council in December 1995.
- The Madrid European Council took note of a Commission report on the key role that could be played by SMEs as a potentially important sector for generating growth and employment opportunities. The Commission's report, however, pointed out that these SMEs needed support through specific measures and a business-environment favourable for the development of SMEs. The Council therefore asked the Commission to make proposals to realise SMEs potential, to improve their competitive position and to encourage them in their business activities both in Europe and internationally. The Commission, in response, approved on 20 March 1996 a proposal for a new Multi-annual Programme for SMEs for 1997-2000[4] which has been submitted to the Council.
- Some progress was also achieved last year with regard to Trans-European networks (TENs) in the transport, telecommunications and energy sectors. The Madrid European Council urged Member States to give top priority to the effective implementation of TEN projects and asked the EcoFin Council to take the necessary decisions to complement the financial resources currently earmarked for these networks.
- Community actions in the context of the Structural and Cohesion Funds, aimed at bolstering the physical and human capital of the weaker Community regions, continue to make an important contribution to the balanced development of all areas.
- Finally, environmental protection initiatives are being actively pursued by the Community internally and at the level of international fora. To increase the job-creating potential of environmental policies, the Madrid European Council emphasised that such policies should be based upon market instruments, including fiscal instruments.

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4 Document COM(96) 98 final of 20 March 1996.

II.1.5. Employment and the labour market

The 1995 Guidelines emphasised the crucial role to be played by more active and more efficient labour market policies in achieving both a high rate of economic growth over many years and in increasing the capacity of that growth to generate jobs. As discussed in section 1, growth trends in 1995 were generally disappointing, with the pace of output expansion being insufficiently high to generate a substantial increase in employment. But provided that resolute progress will be made in further rebalancing the macro-economic policy framework, the Community could progressively move towards a sustained, employment-creating, growth path.

One vital element of the Community's strategy for job creation is the importance of increasing the number of jobs associated with a given level of output ("the employment content of growth"). It should be noted, however, that it is difficult to assess whether underlying progress is being made in this area on the basis of observations for only a short period of time. This is because measured labour productivity varies considerably over the economic cycle, reflecting the lagged response of employment to changes in economic growth. Nevertheless, the available evidence seems to indicate that there has been some improvement in the employment content of growth in a few countries, but no significant change in the majority of countries or for the Community average.

Table 8

Growth, employment and productivity

	Real GDP growth (% p.a.)				Employment (% p.a.)				Labour productivity (% p.a.)			
	74-85	86-90	91-95	*Memo* 1995	74-85	86-90	91-95	*Memo* 1995	74-85	86-90	91-95	*Memo* 1995
B	1.8	3.0	1.3	1.9	-0.3	1.1	-0.4	0.4	2.1	1.9	1.7	1.6
DK	2.0	1.4	2.0	2.6	0.5	0.3	-0.4	1.5	1.5	1.2	2.4	1.1
D	1.7	3.4	1.8	1.9	-0.2	1.5	0.0	-0.3	1.9	1.9	2.6	2.2
GR	2.5	1.9	1.3	2.0	1.0	0.9	0.9	0.9	1.6	1.0	0.7	1.1
E	1.9	4.5	1.4	3.0	-1.4	3.3	-0.4	2.7	3.4	1.2	1.8	0.3
F	2.2	3.2	1.1	2.2	0.1	0.8	-0.1	1.2	2.1	2.4	1.2	1.0
IRL	3.8	4.6	4.8	8.6	0.1	1.0	1.5	3.8	3.7	3.6	3.3	4.6
I	2.8	3.0	1.1	3.0	0.9	0.6	-1.0	-0.4	1.8	2.4	2.3	3.4
L	1.8	4.6	2.4	3.2	0.5	3.1	2.7	2.5	1.2	1.5	-0.3	0.7
NL	1.9	3.1	1.9	2.4	-0.1	1.9	0.7	1.4	2.0	1.2	1.2	1.0
A	2.2	3.0	2.0	1.8	0.7	0.7	1.1	-0.1	1.6	2.2	0.9	1.9
P	2.2	5.1	1.1	2.5	-0.4	1.1	-0.4	-0.6	2.6	3.9	1.5	3.1
FIN	2.7	3.4	-0.8	4.2	0.3	0.2	-3.6	2.2	2.4	3.2	2.9	2.0
S	1.8	2.3	0.1	3.0	0.8	1.0	-2.2	1.6	1.0	1.2	2.3	1.4
UK	1.4	3.3	1.2	2.4	-0.2	1.8	-1.2	0.6	1.6	1.5	2.4	1.8
EUR	2.0	3.3	1.3	2.5	0.0	1.3	-0.5	0.6	2.0	1.9	2.0	1.9
USA	2.3	2.8	2.2	2.0	1.8	2.1	1.0	1.5	0.5	0.6	1.1	0.6
JAP	3.6	4.5	1.3	0.9	0.7	1.5	0.8	0.3	3.0	3.0	0.5	0.6

Source: Commission's Spring 1996 forecasts.

In Spain, labour market reforms introduced in the most recent years seem to have contributed to a very strong employment growth in 1995 (2.7 per cent against a background of 3 per cent GDP growth) and this is expected to continue in 1996. Also in France, the Netherlands and to a lesser extent Belgium, recent measures seem to have contributed to a somewhat more favourable employment response to growth in 1995 than would have been expected on the basis of historical trends. For Denmark the favourable employment response may be partially due to the active labour market policies pursued. Essentially reflecting buoyant economic activity, Ireland experienced very strong employment growth in 1995 for the second consecutive year. In contrast, the employment performance in Germany has been hampered by a continuing shake-out in the country's large manufacturing industries under the pressure of a deterioration in international cost competitiveness, while significant job losses have been experienced in Italy in those service sectors increasingly exposed to competitive pressures and hurt by several years of very weak domestic consumption growth.

The Guidelines also underlined the importance of both the 5 priority areas identified by the Essen European Council and of the latter's call to Member States to implement this strategy by preparing multi-annual programmes spelling out their policy intentions in this area. By providing a coherent presentation of the existing or planned national measures for the implementation of the strategy, these programmes should become an important instrument for monitoring and assessing progress in implementing labour market policies. To ensure their effectiveness, they should be better coordinated with the convergence programmes, indicating that the achievement of convergence, growth and employment is inextricably linked. Some changes in their present content and format will also be required, including national targets for specific measures and greater emphasis on medium and longer-term issues.

The first assessment of the progress achieved in implementing the Community's employment strategy was presented in a joint report from the EcoFin and Social Affairs Councils and the Commission to the Madrid European Council. The report highlighted and commended the major efforts deployed by the Member States since Essen, in particular the acceptance by countries of the necessity of adopting an integrated approach based on the link between macroeconomic and structural employment policies. However, it also stressed that if a decisive improvement in the Community's employment situation was to be realised then an additional impetus would have to be given to labour market reforms in the Member States. A range of measures were singled out in the report as being essential to the strengthening of national initiatives in relation to employment reforms. On the basis of the recommendations contained in the joint report, the Madrid European Council urged Member States to prioritise a number of areas of action in their multi-annual employment programmes. On the basis of the programmes and a set of indicators, the joint effort to improve both the employment situation and the effectiveness of measures will be assessed at the Community level.

Finally, since Madrid the debate on labour market reform has centred on, and is encapsulated in, the proposal of the Commission President for a Confidence Pact for Employment. The Pact is intended to give substance to the Madrid Council's affirmation that the objective of job creation remains the key policy priority for the European Union over the coming years. The macroeconomic and structural policy framework of the pact will be based on the strategy developed in the present and previous Guidelines with the relevant Community instruments also being used to engender dynamism, growth and employment. The Pact aims at arriving at concrete policy commitments involving the Social Partners with measures specifically related to employment creation.

II.2. Economic outlook

The worsening economic climate in late 1995 and early 1996 has complicated the task of making progress towards the objectives of reducing unemployment and restoring sound public finances in the Community. However, a recovery in economic activity is expected to take place in the second half of 1996 and in 1997. This will lead to renewed job creation and reverse the current upward trend in unemployment. But in order to achieve a significant and durable reduction of unemployment, it is necessary to maintain strong growth of economic activity over a sustained period and to make further progress in the area of structural reform.

II.2.1. Growth prospects

The recent economic slowdown, job insecurity and uncertain income prospects have sapped confidence among consumers. Business confidence has suffered from large unwarranted shifts in exchange rates, from the absence of clear signs of a pick-up in final demand and from persistent structural weaknesses. Nevertheless, signs are emerging that the decline in confidence has come to a halt and demand may be picking up again in a number of countries. Consequently, economic activity in the Community is expected to bottom out in the course of the first half of this year.

On the basis of sound supply-side fundamentals (in particular low inflation and relatively strong average investment profitability) and more favourable monetary and financial conditions, the Community economy is expected to see a recovery in the second half of 1996, reinforced by the end of the ongoing stock adjustment. The expansion is expected to gradually strengthen in 1997. In the Commission services' latest Economic Forecasts, economic growth in the Community as a whole is expected to be around 1½ per cent this year followed by growth of around 2½ per cent in 1997. The upswing is expected to be driven by relatively strong extra-Community exports, a renewed strengthening of capital formation and continued moderate but gradually accelerating private consumption.

Table 9

Real GDP

(Real annual percentage change)

	1993	1994	1995	1996	1997
B	-1.6	2.2	1.9	1.1	2.3
DK	1.5	4.4	2.6	1.3	2.7
D	-1.2	2.9	1.9	0.5	1.8
GR	-1.0	1.5	2.0	2.0	2.5
E	-1.2	2.1	3.0	2.0	2.9
F	-1.5	2.7	2.2	1.0	2.1
IRL	3.1	6.7	8.6	5.6	4.9
I	-1.2	2.1	3.0	1.8	2.7
L	0.0	3.3	3.2	2.6	3.0
NL	0.2	2.7	2.4	1.8	2.5
A	0.4	3.0	1.8	0.7	1.1
P	-1.2	1.0	2.5	2.3	2.8
FIN	-1.2	4.0	4.2	3.0	3.6
S	-2.2	2.6	3.0	1.2	2.0
UK	2.2	3.8	2.4	2.4	3.0
EUR	-0.6	2.8	2.5	1.5	2.4

Source: Commission's Spring 1996 Forecasts.

In Germany, France and a number of neighbouring countries, the adverse effects of the strong currency appreciation in spring 1995 will gradually subside, partly due to a significant reversal of the initial currency overshooting. Aided furthermore by a considerable reduction in interest rates and an expected restoration of confidence, activity is expected to pick up during 1996, strengthening into 1997. In Italy, Sweden, Spain and other countries, a continued rebalancing of the macroeconomic policy-mix, which has helped their currencies regain, to varying degrees, lost ground, is likely to help lower short- and long-term interest rates and spur confidence, thereby supporting a recovery in domestic demand no later than the second half of 1996 while reducing the reliance on exports for growth. In the United Kingdom, the recent easing of monetary conditions, improvements in the housing market and a favourable competitive position should sustain continued, non-inflationary growth.

Nevertheless, the economic outlook remains subject to substantial uncertainties. In countries whose currencies appreciated in 1995 the effects of competitiveness losses have not yet been fully overcome, and in most countries whose currencies depreciated in 1994-95 interest rate differentials relative to the DM remain relatively high. In the current apprehensive climate and given high unemployment, the positive response of business and consumer spending to improved monetary and financial conditions and to the reduction in fiscal imbalances could be weaker or take place later than normal.

Furthermore, if progress towards sounder public finances and structural reform were to be hampered by rising social and political resistance, this would undermine the credibility of stated economic policy objectives and might add to doubts amongst some observers as to whether a sufficient number of Member States would be ready to participate in EMU at the starting date of 1 January 1999. Such developments would likely lead to an increase in long-term interest rates and could create a risk of tensions in foreign exchange markets. This would have severe implications for the chances of a renewed and sustained recovery and job creation.

However, some of the uncertainties surrounding the outlook may also point in a positive direction. Since the Community is currently enjoying favourable underlying economic fundamentals and the rebalancing of the policy-mix is expected to continue, the revival in economic activity could surprise in a positive manner once confidence is restored.

II.2.2. Employment trends

Employment -- Given the anticipated weak expansion of economic activity in early 1996, employment trends are expected to remain weak in the months ahead. However, provided economic growth picks up as forecast, job creation should turn positive again in the course of the second half of 1996 and gain momentum in 1997. Overall employment is forecast to grow by a meagre ¼ of a per cent this year and by ½ of a per cent next year.

Not all Member States are expected to share in this modest pick-up in job creation in 1996. In Germany and Austria, employment is expected to fall considerably. If this prediction holds true, 1996 will be the fifth consecutive year of job losses in Germany where the economy is beset by a high relative cost level. In most other Member States, the expectations of job growth have likewise been revised downwards. In Belgium, Denmark, France and Portugal, employment is now expected to stagnate or fall this year. On the other hand, employment creation is expected to remain relatively strong (1 per cent or more) in Greece, Spain, Ireland, Luxembourg, the Netherlands, Finland and the United Kingdom. On current growth assumptions, employment is forecast to pick up more widely in 1997. But with significant job shake-outs expected to continue in the manufacturing sector, employment growth is expected to remain negative in Germany and, due to low economic growth, also in Austria.

Table 10
Labour market prospects

	Employment growth (percent per year)			Unemployment rate (% of labour force)		
	1995	1996	1997	1995	1996	1997
B	0.4	-0.1	0.7	9.9	10.1	9.8
DK	1.5	0.0	0.7	6.8	6.1	5.8
D	-0.3	-0.8	-0.1	8.3	9.3	9.4
GR	0.9	1.0	1.2	9.1	9.1	9.0
E	2.7	1.4	1.5	22.9	22.5	22.1
F	1.2	0.0	0.6	11.5	11.7	11.7
IRL	3.8	2.3	1.7	14.4	13.4	12.8
I	-0.4	0.2	0.4	11.8	11.8	11.7
L	2.5	1.7	2.6	2.9	3.0	2.9
NL	1.4	1.0	1.4	7.3	7.2	7.0
A	-0.1	-1.0	-0.4	4.0	4.6	5.1
P	-0.6	-0.1	0.5	7.2	7.4	7.2
FIN	2.2	1.7	2.1	17.2	16.3	15.0
S	1.6	0.6	1.0	9.2	8.8	8.3
UK	0.6	0.9	1.0	8.8	8.4	8.0
EUR	0.6	0.2	0.6	10.9	10.9	10.8

Source: Commission's Spring 1996 Forecasts.

Unemployment trends -- Against the background of sluggish job growth in the Community in 1996-97, unemployment is expected to rise further in the coming months, before starting to head downwards slowly in the course of the second half of 1996. For the year as a whole, the unemployment rate is expected to remain unchanged at last year's level of almost 11 per cent of the civilian labour force. Next year, it may decline slowly to 10¾ per cent on average, possibly reaching 10½ per cent by the end of the year.

The trends in unemployment in the individual Member States are largely a reflection of the expected employment trends. This year, the jobless rate is expected to rise significantly (by ½ a percentage point or more) in Germany and Austria although relative to the Community average joblessness remains relatively low in the latter country. Belgium, France and Portugal may also see a deterioration and the slow growth of employment is sufficient only to stabilise unemployment in Italy.

On the other hand, unemployment is likely to continue falling in six Member States. This includes the three countries which are hardest hit by high unemployment (Ireland, Finland and Spain) although the level of joblessness continues to be extremely high in these countries. In all three, the impact of strong employment growth on the jobless figures is partly off-set by a significant increase in the labour force. The most positive developments are expected in the United Kingdom and Denmark where a further reduction of around ½ a percentage point is expected to bring the unemployment rate to a level significantly below the Community average. In 1997, the level of unemployment is forecast to fall to varying degrees in all Member States except three countries. In Germany and France, the jobless rate is likely to stabilise and in Austria it may rise further.

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For the Community at large, recent growth and unemployment trends have been disappointing. Progress towards the objectives stated in Article 2 of the Treaty, namely the promotion of sustainable, non-inflationary growth and a high level of employment, have not been adequate. And recent as well as prospective developments has cast doubts on the feasibility of achieving the objectives set out in the Commission's 1993 White Paper on Growth, Competitiveness and Employment of creating 15 million additional jobs and cutting unemployment by half (relative to its 1994 level) by the year 2000. Therefore, resolute efforts in both the macroeconomic and the structural fields aimed at strengthening sustainable job creation must be undertaken.

II.2.3. Convergence

Price stability -- Progress in reducing inflation in the Community and in the Member States is expected to continue this year and next. Average inflation in the Community, as measured by the deflator of private consumption, is expected to fall to some 2½ per cent this year and stay slightly below that level in 1997.

The outlook for low and falling inflation is due not only to the recent widening and the expected persistence of a negative output gap in the Community economy, but also to the reinforced anti-inflation credibility of the economic policy framework. This credibility is well established in Germany and in the countries whose currencies are closely linked to the

DM. In a number of other countries, monetary policy has been conducted with considerable success with the aim of bringing inflation down to a pre-set target. In Italy, Sweden, Spain and Portugal, anti-inflation credibility has been enhanced by the establishment of central bank independence and in Finland by significant moves towards that goal. In these countries, the conduct of fiscal policy has a particularly important role to play in anchoring low inflation expectations and in maintaining the credibility of the currency. In all of them, a determined anti-inflationary stance of monetary policy combined with more credible efforts to place the public finances on a sound footing has, at various times, led to a significant appreciation of their currencies from previous lows. This is likely to further help the process of disinflation and, in turn, should facilitate a gradual relaxation of the monetary policies which have been restraining domestic demand in these countries.

Table 11

Price and wage trends[1]
(Annual percentage change)

	Prices			Nominal wages per head		
	1995	1996	1997	1995	1996	1997
B	1.5	2.0	1.8	1.9	1.7	2.2
DK	1.8	1.8	2.4	3.3	3.9	3.6
D	2.0	1.6	1.6	3.8	2.6	2.4
GR	9.3	8.3	7.0	12.5	11.1	9.6
E	4.6	3.6	3.2	2.4	3.8	3.6
F	1.6	1.8	1.6	2.4	2.3	2.5
IRL	2.5	2.3	2.4	3.1	4.0	5.0
I	5.7	4.1	3.5	5.2	5.4	4.8
L	2.0	1.7	2.1	3.9	3.5	3.8
NL	1.1	1.9	2.0	3.0	1.9	2.5
A	2.2	2.1	1.6	3.8	3.0	2.9
P	4.2	3.1	3.0	4.6	4.6	4.0
FIN	1.1	1.0	1.5	5.3	4.0	4.0
S	2.7	1.7	2.5	3.0	5.2	4.5
UK	2.6	2.7	2.5	3.1	3.6	3.6
EUR	3.0	2.6	2.4	3.5	3.4	3.2

[1] Private consumption deflator and nominal compensation per employee, respectively.

Source: Commission's Spring 1996 Forecasts.

In the Community as a whole and in the majority of Member States the rise in nominal compensation per employee is expected to remain compatible with the need to lock in low inflation and promote job creation. On average, nominal wages are expected to increase by about 3½ per cent this year and slightly less next year, against the background of an expected inflation rate of around 2½ per cent per year. Real wage costs are likely to continue expanding at a rate below productivity growth, thereby contributing to a further rise in overall business profitability.

In some low-inflation countries, particularly in Germany, relatively subdued demand and the competitiveness losses associated with currency appreciation have limited the extent to which labour costs can be passed on to prices, implying a significant squeeze on profit margins in the exposed sectors. Obviously, wage trends cannot adjust instantaneously to movements in exchange rates and in cases of clear overshooting, a market-induced correction of exchange rates is certainly the most desirable option. Still, in order to safeguard the country's competitive position and its attractiveness for private sector investment, it is essential to contain pay settlements whilst at the same time implementing measures to enhance productivity and employment.

Conversely, in some depreciating countries, especially Italy, real wages are expected to recover some of the ground lost over previous years. In these countries, there is a risk that workers will seek to catch up too rapidly on previous years' losses in purchasing power through higher pay claims thereby fuelling a price/wage spiral. Instead, continuing adequate wage behaviour in combination with credible fiscal rectitude should engender an appreciation of these currencies, thereby lessening (imported) inflationary pressures. Such a policy mix was successfully implemented in Sweden last year. But in 1996, the rate of nominal wage increases in Sweden is forecast to rise significantly despite the expected deceleration in consumer prices. This wage behaviour risks being in conflict with the stability objective and does not appear to adequately reflect the need to maintain and create jobs. Moreover, allied with the considerable appreciation of the Krona, it may threaten its external competitive position.

Inflation (deflator of private consumption) is expected to stay below 3 per cent in 1996-97 in the countries which already satisfy this goal. And in the seven countries where inflation did not exceed 2 percent last year (Belgium, Denmark, Germany, France, Luxembourg, Netherlands and Finland) it is expected to remain below that value this year and next (with the possible exceptions of Denmark and Luxembourg). The 1995 Broad Guidelines contained a recommendation that countries with an inflation rate in the range of 2 to 3 per cent should aim at progressing towards or below 2 per cent. In this regard, some progress is expected to take place in 1996 (Ireland, Austria and Sweden) but, at least on current forecast assumptions, less so in 1997 (due to a possible upward movement in Denmark, Ireland, Luxembourg and Sweden).

Visible progress is expected to take place in the four countries where inflation currently exceeds 3 percent. Assuming continued efforts, inflation in Spain and Portugal is likely to approach the upper limit of the Guidelines objective (3 per cent) by 1997. Against the background of a marked slowing in import price increases and no further indirect tax increases, consumer price inflation in Italy is expected to decelerate to 3½ per cent in 1997. In Greece, with more determined efforts, especially on the budgetary front, it should be possible to reduce inflation further than the 7 per cent currently anticipated for 1997.

Budgetary outlook for 1996-97 -- A large number of Member States have taken significant steps to consolidate their public finances in 1996 and, in many cases, also in 1997. According to the Commission services' estimates of cyclically-adjusted fiscal balances, present budget plans imply a reduction in the underlying fiscal deficit of the order of ¾ of a percentage point of Community GDP in 1996 and, on currently known policies, a further ¾ a percentage point in 1997. Nevertheless, in the latest forecasts of the

Commission services, which take into account slower growth than previously foreseen, the outlook is for a considerably smaller reduction in the general government net borrowing in the Community in 1996 than had previously been envisaged. The average fiscal deficit is expected to be reduced by ½ a percentage point to just below 4½ per cent of Community GDP in 1996 (versus 3¾ per cent of GDP forecast in Autumn 1995).

The Economic Forecasts include a scenario for 1997 on the basis of measures which have already been adopted or announced in sufficient detail. This does not include general policy intentions for which specific measures are not yet known. The forecasts take into account the economic policy packages announced in detail during April and early May by the German, French, Austrian and Swedish governments. However, they do not incorporate the planned adjustment measures recently announced by the Belgian government for 1997 because the measures to be taken were not known in sufficient detail at the time of the elaboration of the forecasts. In addition to those mentioned, a number of other Member countries are expected to take measures to improve their budgetary position between now and 1997. On the basis of currently known measures, and aided by improving cyclical conditions and low interest rates, the scenario for 1997 points to a reduction in the average actual budget deficit to 3½ per cent of GDP next year.

Table 12

Actual and cyclically-adjusted general government budget balances

(percent of GDP)

	Actual balance *Level*			Cycl. adj. balance *Annual change*[2]		
	1995	1996	1997[1]	1995	1996	1997[1]
B	-4.5	-3.2	-3.7	0.5	1.8	-0.9
DK	-1.4	-0.9	-0.6	1.6	1.0	-0.2
D	-3.5	-3.9	-2.9	-0.9	0.3	1.2
GR	-9.2	-8.1	-6.9	2.6	1.0	0.8
E	-6.2[3]	-4.8	-3.7	0.4	1.5	0.7
F	-5.0	-4.2	-3.0	0.5	1.1	0.9
IRL	-2.4	-2.0	-1.6	-2.0	0.3	0.6
I	-7.1	-6.3	-5.2	1.3	0.8	0.8
L	0.3	0.7	0.3	-2.0	0.4	-0.6
NL	-3.4	-3.5	-2.9	-0.2	0.2	0.4
A	-6.2	-4.6	-3.1	-1.6	2.2	2.0
P	-5.4	-4.4	-3.7	0.2	0.9	0.5
FIN	-5.6	-3.3	-1.6	-1.2	1.5	0.7
S	-8.1	-5.2	-3.1	1.1	2.8	1.5
UK	-6.0	-4.4	-3.7	0.6	1.5	0.3
EUR	-5.0	-4.4	-3.4	0.3	0.9	0.8

[1] Based on currently announced measures.

[2] A positive number denotes an improvement in the cyclically-adjusted balance.

[3] This time series includes social security contributions still on a cash basis. Preliminary accounting on an accruals basis by national sources shows figures of -5.8% of GDP for 1995. The time series will be updated on an accruals basis once certain issues concerning the correct application of statistical definitions have been clarified.

Source: Commission's Spring 1996 Forecasts.

Table 13

General government gross debt

(percent of GDP)

	Level			Annual change	
	1995	1996	1997[1]	1996	1997[1]
B	133.7	132.2	130.6	-1.5	-1.6
DK	71.9	71.0	68.7	-0.9	-2.3
D	58.1	61.5	62.4	3.4	0.9
GR	111.5	111.8	111.4	0.3	0.4
E	65.7	67.8	68.0	2.1	0.2
F	52.4	56.1	57.8	3.7	1.7
IRL	85.5	81.3	77.3	-4.2	-4.0
I	124.8	124.5	122.8	-0.3	-1.7
L	5.9	6.2	6.8	0.3	0.9
NL	79.0	79.4	78.7	0.4	-0.7
A	69.4	72.4	73.9	3.0	1.5
P	71.6	72.2	71.8	0.6	-0.4
FIN	59.6	62.5	63.2	2.9	0.7
S	79.9	80.8	79.6	0.9	-1.2
UK	54.0	55.5	56.2	1.5	0.7
EUR	71.2	73.9	74.3	2.7	0.4

[1] Based on currently announced measures.

Source: Commission's Spring 1996 Forecasts.

The expected degree of budgetary improvement is insufficient to halt the rise in the average gross debt-to-GDP ratio in the Community, which is projected to increase by almost 3 percentage points to 74 per cent of GDP this year before roughly stabilising at that level in 1997. In 1996, debt ratios are expected to rise in all Member States except four (Belgium, Denmark, Ireland and Italy) but in 1997 debt ratios are expected to stabilise or fall in about two thirds of the Member States.

All countries except Germany and the Netherlands are forecast to reduce their *actual* deficits in 1996, but progress is generally expected to fall short of the targets set both in national convergence programmes and in the 1995 Guidelines. Only 3 Member States (Denmark, Ireland and Luxembourg) are expected to have actual deficits below the 3 percent reference value this year. Particularly large reductions in the budget deficit (close to 1 percentage of GDP or more) are expected this year in Belgium, France, Greece, Spain, Italy, Austria, Portugal, Finland, Sweden and the United Kingdom.

In the "unchanged policy" scenario for 1997, Germany, France, the Netherlands and Finland would join the group of countries with deficits below the Maastricht reference value and Austria and Sweden are expected to come very close to this value. In a number of countries, where further measures have not yet been disclosed in sufficient detail the additional effort required to reach the 3 per cent reference value would be of the order of ¾ percent of GDP (Belgium, Spain, Portugal, and the UK). Only in Italy and in Greece is the deficit expected to exceed the reference value by a wider margin in the current scenario with the deficit forecast at 5¼ and 7 percent of GDP, respectively.

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Faced with an unsatisfactory growth and employment performance, there is an urgent need to relaunch the recovery process in the Community. The challenge facing policy-makers is to generate a renewed strengthening of confidence and job creation over the short-run while enhancing the conditions for stronger growth and employment over the medium term. This requires both the provision of a supportive macroeconomic policy framework, entailing a sound rebalancing of the macroeconomic policy mix, and intensified efforts in structural policies to reduce unemployment and enhance the Community's competitiveness. The Commission's 1996 Annual Economic Report gave a detailed analysis of the available policy options in the current situation. Furthermore, the Commission has received opinions of the European Parliament and the Social and Economic Committee on this report and discussed it with the Social Partners. Against this background, the Recommendation for the 1996 Broad Economic Policy Guidelines sets out the policies which are necessary for achieving the Community's objectives in terms of growth, employment and convergence.